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2007

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MPRA Paper No. 7300, posted 22. February 2008 06:48 UTC

THE REAL INTEREST RATE DIFFERENTIAL: INTERNATIONAL EVIDENCE BASED ON NONLINEAR UNIT ROOT TESTS

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ABSTRACT

This paper aims at testing international parity conditions by using nonlinear unit root tests advocated by Kapetanios et al. (2003, KSS). Results from the KSS tests based on 17 countries (G7 and 10 Asian countries) overwhelmingly show that the adjustment of real interest rates towards the RIP follows a nonlinear process except for the Malaysian relationships with both the US and Japan. Overall, the empirical results are in favor of RIP using the US and Japan as the center countries but only if nonlinearities are accounted for in the data generating process. Our findings confirm that interest rate differentials, like the real exchange rates reported in recent literature, display a nonlinear mean reversion process.

Keywords: real interest parity, nonlinearities, unit root tests

JEL Classification: F32, F36